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SUBJECT: CANADIAN MONETARY POLICY:
NEW CENTRAL BANK GOVERNOR TAKES THE HELM IN ROUGH WEATHER

REF: (A) 07 OTTAWA 1991 (CANADIAN DOLLAR)

(B) 07 OTTAWA 1869 (CARNEY APPOINTMENT)
(C) 07 OTTAWA 0921 (HARPER GOVT AND BUSINESS)

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¶1. (U) SUMMARY/INTRODUCTION: Mark Carney begins a seven-year term as Governor of the Bank of Canada on Friday, February 1 (ref B). Carney, who gained his first degree at Harvard, is not a career central banker. He worked for merchant bank Goldman Sachs in various assignments for thirteen years prior to coming to Ottawa in 2003 for stints at the Bank of Canada and then the federal Department of Finance.

¶2. (SBU) Carney succeeds David Dodge, a successful Governor who oversaw a period of sustained strong growth and low inflation since ¶2001. The incoming Governor inherits a more dynamic economic scene. This message lists some short- and long-term issues that confront the Bank as Carney takes office. The issues involve facilitating credit market operations, balancing inter-regional disparities in growth and inflation, parrying pressures to stabilize the currency's value (ref A), gauging and reacting to the impact of the U.S. slowdown on Canada, and managing the Bank's relationship with the Department of Finance (ref C) in a period when economic issues are likely to be rising on the public agenda. END SUMMARY/INTRODUCTION

¶3. (U) BIOGRAPHICAL NOTE: Mark Carney received a bachelor's degree in economics from Harvard University in 1988. He then received a master's degree in economics in 1993, and a doctorate in economics in 1995, both from Oxford University. Carney had a thirteen-year career with Goldman Sachs in its London, Tokyo, New York and Toronto offices. He was subsequently one of several Deputy Governors of the Bank of Canada for fifteen months from August 2003 until his appointment as Senior Associate Deputy Minister of Finance in November 2004. In addition to his domestic responsibilities in the Department of Finance, Carney also served as Canada's Finance Deputy at the G-7, G-20, and the Financial Stability Forum. He has been a good Embassy contact.

¶4. (U) ECONOMIC BACKDROP: Since significantly opening up their trade and investment policies (mid 1980s-mid 1990s) while simultaneously waging a tough fight against inflation (late 1980s-early 1990s) and later controlling escalating government deficits and debt (mid-late 1990s), Canadians have enjoyed healthy

growth and employment with moderate inflation. Real annual GDP growth has averaged around three percent over the past decade, unemployment has fallen to lows not seen since the early 1970s, and inflation - which is the central bank's main focus - has remained within the target band of 1 to 3 percent.

¶5. (U) Since 2002, surges in commodity prices and in Canada's trade with Asia have tilted growth and job creation toward resource-rich western provinces, contributed to a steep appreciation of the Canadian dollar against the U.S. dollar (by 50-60 percent over five years), and sparked talk that Canada's economy might be "decoupling" from the United States. Turbulence in U.S. credit and housing markets since mid-2007 has had a relatively limited impact in Canada due to the separateness of the two countries' banking systems and because Canadian housing prices rose much less steeply than in the United States. Still, Canadian credit markets have tightened
Qthe United States. Still, Canadian credit markets have tightened recently, and the January 2008 equity market correction was felt about equally in both countries.

¶6. (SBU) CARNEY'S CHALLENGES: Following are overviews of some key issues facing the new Governor as he takes up his post:

a. (SBU) CREDIT MARKETS: Canada's C$33 billion market for non-bank asset-backed commercial paper (ABCP) was frozen in August on agreement among the market players. Carney's arrival in the Governor's chair coincides with the expiry (or rollover) on January 31 of the market standstill agreement that was brokered in the fall by an investors committee, led by veteran lawyer-executive Purdy Crawford. The committee is asking Canada's five major banks, as well as foreign banks (including HSBC, Deutsche Bank, and Citibank) who are major players in the Canadian ABCP market, to contribute to a C$14 billion fund to underwrite liquidity needed to re-start trading of ABCP. While little information is publicly available, it is reasonable to think that behind the scenes, the Bank of Canada

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(along with the federal bank regulator, the finance department and others) may be involved in some arm-twisting of market participants to persuade them to contribute and comply. The market restructuring process is expected to go on for at least the first few months of Carney's tenure.

b. (SBU) REGIONAL IMBALANCES: Arguments about inter-regional economic (and political power) disparities are a large, perennial feature of Canadian public life. The boom in demand for Canadian energy, minerals, and wheat has produced tight labor markets and inflationary pressures in much of western Canada, while slumps in forest products and the auto industry (exacerbated by the currency appreciation) are disproportionately hurting the eastern provinces, particularly Ontario but also Quebec. Since federal monetary policy cannot discriminate among such regions, policymakers face conflicting pressures, with some industries demanding easier credit and a softer currency, even as wages in some sectors/regions are jumping at double-digit annual rates.

c. (SBU) CURRENCY TARGETING: The Bank of Canada's macroeconomic mission is inflation control. The Canadian dollar trades freely and the central bank's only avowed role in the exchange rate is to ensure that market movements are orderly. Even so, the Bank regularly comments on whether given exchange rates are "appropriate" or "justified." Given the Canadian dollar's steep appreciation since 2002, many business leaders have demanded action to restrain the currency's climb - particularly in the fall of 2007 when the Canadian dollar's value briefly touched US$1.10. These demands have abated as the current rate, about US 1.00 ("dollar parity"), is close to the Bank's US 98 cent projection, based on economic fundamentals. Still, if significant, upward exchange rate volatility returns during his tenure, Carney can expect to be pressed to veer from his inflation-fighting mandate.

d. (SBU) GAUGING THE EFFECT OF AND REACTING TO THE U.S. SLOWDOWN: The energy/commodities boom and trade with Asia have made Canada marginally less reliant on U.S. growth, and Canadian housing markets

remain healthy. Still, about eighty percent of Canada's exports go to the United States, and U.S. residents remain by far Canada's main source of tourism and foreign investment. Two leading Canadian industries, forest products and autos, have been hit hard by the slowdown south of the border. Consequently, the top debate among Canadian economists now is over just how strongly the country's overall growth will respond to U.S. economic developments. Carney's view of the answer bears directly on the Bank's coming interest rate decisions, which follow in the wake of January's substantial reductions by the U.S. Federal Reserve. The Bank last cut its key interest rate by 25 basis points on January 22, the same day the Fed slashed its benchmark rate by 75 basis points, creating a 50 basis point divergence between the two rates. The gap grew to 100 basis points on January 30 when the Fed delivered another 50 point cut. The next scheduled review of rates by the Bank of Canada is March 4.

e. (SBU) GETTING ALONG WITH THE BOSS: The formal independence of Canada's central bank from the government is among the weakest in the G7 countries. The governing law requires the Governor to consult regularly (normally weekly) with the Minister of Finance, Qconsult regularly (normally weekly) with the Minister of Finance, and the Minister has the authority to direct Bank policy "in the event of a profound disagreement between the Bank and the government." Such a situation would likely lead to the Governor's resignation. While there are no signs of policy differences, the Harper government's economic policies have a somewhat populist flavor (ref C) - in some measure due to Finance Minister Jim Flaherty - and the government has shown less than usual sensitivity to the autonomy of supposedly "arm's length" decision-making agencies. In a period of increased economic stress, one of the new Governor's challenges will no doubt be to maintain respectful relations with the Finance Department and to avoid becoming (or letting the Bank become) a lightning rod for discontent with economic policy.

WILKINS